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SUBJECT: Drought's Limited Impact on Kenya's Economy - So Far

Ref: Nairobi 5276

¶1. Summary: Although drought has put 2.5 - 3.5 million Kenyans in Northern, Northeastern and Coast provinces in desperate need of aid, Kenya's economy grew about 5% in 2005, and the Central Bank of Kenya (CBK) forecasts stronger growth in 2006. Unless the March-August long rainy season fails, tourism, agricultural exports, transportation, and other growth sectors are expected to continue to pull the economy forward. The GOK is appealing for international contributions and for debt relief to help it defray an estimated KSh 17 billion (\$233 million) in drought-related expenditures. Inflation led by food prices may rise in the next few months, but strong tax revenues, donor support and fiscal discipline seem likely to keep the GOK budget and interest rates under control. Failure of the long rains, however, would significantly cut growth in 2006. End summary.

Persistent Drought Plagues Certain Districts

¶2. As of January 18, the GOK has claimed that over 37 districts are being impacted by East Africa's prolonged drought, with the most severely affected in North Eastern (Mandera, Wajir, Garissa), Eastern (Machakos, Kitui, Makueni, Kajiado) and parts of Coast (Kwale, Kilifi) provinces. Some of the areas now experiencing severe drought and famine have had consecutive seasonal rainfall deficits since March 2004, culminating in failed crop harvests and badly degraded fodder for the livestock that pastoralist communities rely on. The long rains across the country are expected in late March, but an official at the Regional Centre for Mapping of Resources for Development noted that severe droughts have often been followed by heavy rains and damaging floods.

¶3. Some areas of Kenya, particularly in Western province, had a bumper harvest, and food is available elsewhere in the country. On January 6, the GOK directed that all available maize in the country be purchased to meet the emergency feeding challenges now and in the coming months. The National Cereals and Produce Board (NCPB) has about 218,000 metric tons (MT) of maize, with 180,000 MT for strategic reserve, 30,000 MT for famine relief, and 8,000 MT for commercial purposes. The main bottleneck has been transporting food from surplus areas to drought areas. Assistance to the drought areas is expected to total \$200 million through August of 2006, with \$140 million for food

and \$60 million for transportation, water, livestock and other needs. The Ministry of Agriculture estimated 2005/06 maize production would rise 10% to 2.9 million tons of maize, assuming normal rains March-May.

¶4. On January 9, Special Programs minister John Munyes said 2.5 million persons are on the verge of starvation and/or are victims of the drought. He estimated the total budget for aid at KSh28 billion (\$385 million) or more. He said the Government would contribute Sh17 billion (\$233 million), while NGOs and donors are being asked to contribute the rest. The GOK's assistance to pastoralists would include buying and distributing hay worth Sh300 million, and KSh300 million to buy their emaciated livestock. According to Munyes' data, the GOK had already spent KSh1.3 billion on maize, KSh734 million on beans, KSh421 million of vegetable oil and KSh 337 million of milk powder, and allocated KSh 143.5 million for transportation. On January 17, Munyes raised the number of affected persons to 3.5 million (donors have not yet verified that figure).

Impact on Growth, Budget, Inflation and Interest Rates

¶5. The Central Bank of Kenya estimates that Kenya's GDP grew about 5% in 2005. It has predicted 6% growth in 2006, but recently stated the drought would cause it to revise that forecast downward. On January 18, investment firm Old Mutual Asset Managers (Omam) reduced its 2006 growth estimate from 6.2% to 5%. AIG Global forecast 5.5% growth in 2006, given normal rainfall, but warned a failure of the next rains could drive 2006 growth as low as 3.2%. Nairobi Stock Exchange Chief Executive Chris Mwebesa warned that the drought's impact on agriculture could cut 2006 growth to the 4.5-5.5% range, but that corporate earnings would still

improve compared to 2005. He expressed concern that Finance Minister Mwiaria's decision to slash funding for ministries to fund drought relief could slow economic growth.

¶6. On paper, the GOK has the fiscal resources to buy food in Kenya and transport it to those in need. However, Finance Minister David Mwiraria has recently requested that Kenya benefit from the G-8 debt relief scheme, in part to help the GOK pay for its drought-related commitments. Mwiraria announced the GOK would stay within its budget and keep domestic borrowing at current levels, despite spending billions of shillings providing food to drought-stricken areas, buying livestock and other assistance, by cutting Ministry budgets. The GOK has already borrowed KSh19.9 billion in the first half of the 2005/6 fiscal year out of the 25.3 billion targeted for the whole year.

¶7. In the first four months of FY05-06, the GOK accrued a fiscal deficit of KSh 15.3 billion, while the budget target for the FY was 22.5 billion, or 1.7% of GDP. Some analysts predict the GOK might not need to borrow more to deal with the famine. GOK tax revenue collection in the first half of FY 05/06 rose KSh14.4 billion, or 11.5% YOY. However, much of that tax revenue is supposed to be refunded, so spending it now could cause future shortfalls, should the economy slow.

¶8. Overall inflation from December 2004-2005 rose to 7.6%, and rose 6.04% MOM in November 2005 compared to the 3.72% MOM increase in October, reflecting rising prices of particularly food and drink, fuel and power, and personal goods and services. Nairobi Stock Exchange Chief executive Chris Mwebesa warned that drought could cause inflation to rise to about 12% in 2006, but he expects short-term interest rates to stabilize at around 7-9% because higher-than-expected Government tax revenue and budgetary support provided by donors should reduce Government borrowing. Both OMAM and AIG agree inflation will rise to 12 percent in the first quarter of 2006 due to food price increases, but thought inflation could decline if the long rains are timely and adequate. Interest rates on the benchmark 91-day Treasury bill have risen slowly from 7.81% on November 10,

before the drought became headline news, to 8.26 percent in mid-January. AIG said any increase in GOK expenditure over KSh10 billion could push interest rates up.

Impact on Exports and Balance of Payments

¶9. Tea, horticultural exports led by flowers, and coffee remain Kenya's major export commodities. Although production was not significantly affected before December, the persistent dryness is likely to have an impact soon, making the next rainy season critical. The Kenya Tea Board estimates record production in 2005 of 328 million kilograms due to high rainfall in the key growing areas, and expects continued growth in 2006 given normal rains. However, Kenya Tea Growers Association (KTGA) chairman Titus Korir disagrees. He claims low rainfall since October have caused tea bushes to wilt in some areas, and predicted 2006 production could fall 25-20%. KTGA represents large growers who account for about 40% of Kenya's production.

¶10. Kenya Flower Council chairman Erastus Mureithi said his members have not reported any decline in production so far, but they fear yields will drop if the drought persists. Sicily Kariuki, Fresh Produce Exporters Association of Kenya chief executive, anticipates a 20 - 30% decline in production of fruits and vegetables from December until the forecasted start of the March rains. Horticulture exports were KSh33 billion in 2004, but the industry fears it might lose up to a third of its production this year, as rivers shrink and water levels in boreholes fall. Mrs. Kariuki said small vegetable and fruits farmers who produce most of the vegetables and fruits for export, but do not have boreholes or reservoirs, are the hardest hit.

¶11. Preliminary statistics from the Coffee Board of Kenya report Kenya exported 40,218 tons in the October 2003-September 2004 year, and that higher global prices lifted export earnings 15% to KSh8.2 billion (\$111.7 million). Central and Western Kenya, where the bulk of coffee is grown, did not experience drought, but inadequate March-May rains would likely cut 2006 production below the GOK's

forecast of 65,000 tons.

¶12. To support poor pastoralists whose herds are dying, the GOK is buying cattle and livestock. Some of the livestock is slaughtered and the meat distributed, some is sent to agricultural stations for future use in restocking herds after the drought, and others are being exported. In mid-January, 1,000 head of cattle and 1,500 goats from areas less impacted by the drought and valued at KSh38 million are scheduled for export to Mauritius.

¶13. It will not be clear until the second half of 2006 whether Kenya will need to increase food imports, and what impact that might have on the balance of payments and the currently strong shilling. In the first nine months of 2005, Kenya's balance of payments recorded a \$397 million surplus, as the rising surplus in the capital and financial account overcame deterioration in the current account.

Impact on Wildlife, Tourism Limited, So Far

¶14. Tourism is Kenya's other main export, and is a major employer as well. Drought could affect the strong growth trend in the tourism sector if the animals disperse, die, or move away from parks and reserves in search of water. Kenya Wildlife Service (KWS) spokeswoman Connie Maina recently told the press that wildlife, notably elephants, have left parks in search of water. Maina said the most-affected sanctuaries are the Tsavo National Park, in southeastern Kenya and the highly popular Maasai Mara National Reserve in the southwest. In the Maasai Mara, wardens say that between 60 and 80 hippos have died as water levels in the Mara river drop. Maina said the situation is still manageable, but the problem would become serious if the March rains fail.

Students Have Difficulty Attending School

¶15. Press reports claim that at least 10,000 students in North Eastern Province had not reported to class three days after the semester break ended, presumably because they moved with their family's livestock in search of water and pasture. About 20 schools were reported as deserted by teachers who had fled to towns such as Garissa, Wajir and Mandera because of famine. School principals told the press that the lack of kale, maize and beans was forcing them to find alternative foods for their boarding students.

Prolonged Drought Would Threaten Power and Water Supplies

¶16. Hydropower provides 80% of Kenya's electricity, and a prolonged drought could cause a repeat of the power rationing Kenya experienced in 2000. Demand for power has grown steadily, and is expected to rise 9% in 2006. KenGen Operations Chief Richard Nderitu assured the press there was enough water behind the dams to sustain normal generating levels for the first quarter of 2006, and that KenGen has diversified its sources by expanding geothermal power generation to 16% of production. However, he also admitted the poor rains in 2005 had reduced the water flowing into the reservoirs. The Federation of Kenya Employers estimates failure of the next rains would create a capacity shortfall of between 87MW and 117MW between March and June 2006. Tea Growers Association Chairman Korir claimed the decline in river flow since October has already cut the power supply from large tea producers' own hydropower plants, forcing them to use more expensive diesel generators or to buy power from KenGen. There have also been recent reports that Nairobi and other urban centers may face water rationing (as in 2000) if the long rains are not normal or better in 2006.

¶17. Comment: Although human and animal deaths will likely continue for months, the current consensus is that Kenya can weather the drought without serious damage to the national economy because the most seriously impacted areas are not significant contributors to Kenya's GDP. However, everyone will be watching for the onset of the long rainy season in late March. A shortfall would lead to more serious consequences for the entire economy.

Bellamy